

6- Rules and Regulations for Direct Investment

- A) Instructions Concerning the Rules and Regulations for Direct Investment of Islamic Banks.

**Instructions No. (2/IBS/142/2003)
Concerning the Rules and Regulations for Direct
Investment at Islamic Banks**

Islamic banks investment activity meant to be addressed by these instructions is the investment business practiced by the Islamic banks for their own account in non-banking or non-financial areas, such as trade and real estate, which results in the banks acquisition of movable and immovable assets, either for the purposes of trading seeking to generate profits from selling such assets to customers, or for investment in order to achieve periodic returns and / or benefit from capital appreciation.

These instructions do not apply to the financial investment in the securities portfolio, which comprises financial instruments like shares, finance sukuk and other financial investment instruments issued by other parties, as these are separately addressed in the instructions concerning “the organization of financial investment policy at Islamic Banks”.

It is understood that the direct investment business involves additional risks beside the risks associated with the normal banking and financial activities practiced by banks, such as finance and financial investment, including normal risks, market risks and liquidity risks emanating from these activities. Therefore, these activities must be practiced within the framework of investment policies that incorporate the appropriate strategies for these areas of business, and which are based on sound grounds that take into account the type and size of risk in each activity and the general and economic conditions within which the relevant sectors operate, thus ensuring the mitigation of the risks banks may encounter in these fields. Prudent management of business in this connection is of prime importance for banks compared to other economic institutions that practice this type of business, because those banks are bound to protect the interests of funds of their depositors which represent part of the wealth of the society that must be preserved and grown. Accordingly, the appropriate methods and techniques must be adopted to avoid undue losses, and banks are required to use such funds in developing various economic sectors.

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Based on the rules of article (86) of law No. 32 of the year 1968 concerning Currency, the Central Bank of Kuwait and the Organization of the Banking Business and the laws issued in amendment thereof, which authorizes the Islamic Bank to practice direct investment activities in accordance with the rules set-up by the Central Bank Board of Directors, and the rules of article (98) of the said law which authorizes the Central Bank to determine for the Islamic Banks the maximum limit of the transactions pertinent to a certain activity, the Central Bank Board of Directors has resolved at its meeting of 19/10/2003 to issue the following rules and regulations concerning Islamic Banks direct investment, and which represent the minimum rules that must be observed by Islamic banks when practicing direct investment activities.

First : Controls Regulating Direct Investment Activities:

(1) Banks must set-up a written investment policy approved by the board of directors for each of the direct investment activities practiced by the bank, so that such policy will be the basis for taking the appropriate decisions in this respect. This policy must observe the following rules, at minimum:

- a) Creating balance between the objective of maximizing the return on the investment and the developmental role of the banks in contributing to the growth of the other economic sectors, as they are licensed to mobilize the savings of the society segments. Hence, banks may not speculate on the prices of the assets constituting the object of the investment, and must refrain from any practices causing harm to the conditions of healthy competition with other economic institutions practicing the same business.

On the other hand, the investment policy must balance between minimizing risk, on the one hand, and achieving the appropriate return on the investment, on the other hand.

- b) The bank must adopt a sound policy in managing its assets and liabilities in a manner ensuring the appropriate level of liquidity to meet contingent needs without having to liquidate assets on the short term, which may result in losses for the bank, taking into account that a part of the direct investment may be concentrated in real estate properties which are not usually easily disposable.

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- c) Minimizing investment risks (normal risks, market risks, etc.), basically by thorough study of the subject assets markets, their developments and future outlook under the general and economic conditions of relevant to these markets. The policies must include the maximum limits for the types of direct investments and the risks associated therewith.

In this respect, the bank must take into account the size of the similar assets constituting the object of the lease financing (ending-up with acquisition), as these assets are considered free hold of the bank (the lessor) according to the Shareea'a rules, and hence the bank bears the risks associated with such ownership.

- (2) The bank must create balance between its direct investment policies and finance policy in a manner that does not affect the role of the bank in extending finance to various economic sectors. The bank must also coordinate these policies, to the extent possible, in relation to the assets the bank needs for executing the finance transactions with customers.
- (3) The bank must establish an independent specialized unit, or a specialized unit within the risk management department the bank is committed to establish in accordance with the "General Guidelines for the Internal Control Systems in Islamic banks and External Auditors Reports on the Evaluation of Those Systems". The mentioned department shall be responsible for identifying, measuring and managing the types of risks inherent in the direct investment, and shall conduct the necessary studies in this regard. This unit should be provided with professional staff of appropriate experience and capabilities to manage the risks in the areas of the above mentioned activities.

Second : Maximum Limits for Direct Investment:

The total book value of the assets constituting the object of the direct investment may not exceed 100% of the capital of the bank in its comprehensive concept, as explained in the instructions issued in connection with the capital adequacy ratio for Islamic Banks. The following rules must also be observed:

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- a. The book value of the assets constituting the object of the direct real estate investment, whether for trading or for investment purposes, may not exceed 50% of the capital in its comprehensive concept, and provided that the amount of investment in one single property may not exceed 10% of the capital in its comprehensive concept.
- b. The book value of the assets constituting the object of commercial investment may not exceed 10% of the capital in its comprehensive concept.
- c. The book value of the assets constituting the object of any other type of direct investment other than those mentioned in items (a) and (b) above, may not exceed 10% of the capital in its comprehensive concept.

When calculating the above ratios, the book value of the bank's investments in the capital of subsidiaries and affiliates practicing similar business, must be added to the numerator of the ratio.

In the event the banks desires to exceed the above mentioned ratios, the bank must obtain the Central Bank's prior approval in writing by submitting an application supported by the justifications and reasons for which the excess is requested and the period of the excess, noting that such cases must be kept to the minimum and to events of absolute need.

Third : General Rules:

- (1) Each direct investment activity must be practiced through an independent department manned with professional staff of high efficiency and appropriate experience to manage this activity. The organization structure of the bank must show the structure of these departments.
- (2) A system of powers and responsibilities must be set-up for the management of direct investment activity. Such a system must be approved by the bank board of directors, and must include the formulation of necessary committees, with clear and accurate definition of the method of their work and the powers delegated to them and to various managerial levels entrusted with the responsibility of exercising direct investment activities. In defining these powers, the

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bank must differentiate between the local and foreign direct investments. Controls must be put in place for exceptions to these powers.

(3) The bank must take necessary actions to ensure compliance, by all managerial levels concerned with the implementation of the established investment policies, including the maximum limits and the limits of established powers and responsibilities.

(4) The bank must perform the following:

a- Review the investment policies for direct investment periodically, (at least once annually), and introduce the necessary amendments thereto in the light of the general policy of the bank and the developments in the respective markets.

b- Provide the Central Bank of Kuwait with investment policies in the above mentioned areas, as well as with any future amendments thereto.

(5) The executive management of the bank must prepare quarterly reports for presentation to the bank's board of directors on each of the bank's direct investment. The reports must include an evaluation of the bank's investments in these areas, the profits and losses resulting there-from and the future directions in respect of these investments.

In addition to the above mentioned quarterly reports, the chief executive officer of the bank must be provided with monthly reports, or with shorter- period reports, showing the evaluation of these investments and the profits and losses resulting there-from.

Fourth : These instructions shall be in effect from the date of their notification.